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DOW THEORY LETTERS

"THE MARKET AS INTERPRETED UNDER THE DOW THEORY"

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CONFLICTING VIEWS. I have received the latest report issued by a large and respected investment service. This organization uses its own estimates of values as the basis of all its market attitudes and predictions. According to this service, "the danger signals are (now) flying all over." We are told that the intrinsic value of the D-J averages, based on the last 12 months' earnings, is 16% below the current market price. A readjustment to the normal price, this report warns, would imply a drop of at least 30%.

Another leading advisory letter to which I subscribe states that the D-J industrials will probe the 750 area by the end of 1959. This service argues that because of the huge reservoir of uninvested funds and the fear of continued inflation, increasingly larger amounts of cash will be driven into the securities market.

My conclusion, upon reading these two reports, is that I would be thoroughly frightened if I did not have Dow's Theory of the price movements to rely upon. For the Dow Theory takes into account the combined predictions, guesses, and hopes of all the bullish and bearish services together with all their respective clients. Also registered in the averages is the total of the country's speculators, insiders, tipsters, statisticians, corporate presidents, elevator operators, and all their investment-minded wives.

The first mentioned service may be correct in its analysis. But it forgets that the averages measure not last year's earnings but those which will be recorded next year. This service also disregards the fact that the market evaluates price-earnings ratios differently in the final, speculative phase of a bull market than in the first cautious phase. The second service may discover that the market has a long history of mocking quackish predictions. In fact, the averages seem to take great delight in refusing to conform to the pattern laid out for them by the owners of advisory services.

DOW'S THEORY SURVIVES. Dow's Theory has survived 62 years on the "firing line," while most of the other systems which attempt to predict the trend through the use of such sundry devices as pig iron production charts, population growth trends, inflation graphs and stock-bond yield ratios have been discarded. Usually these other methods are scrapped with the advent of the first unforeseen bear market. Dow's Theory continues to serve investors because (1) it is not based on any dogmatic assumptions (such as fixed price-earnings formulas), (2) it has been successfully tested against six decades of coming events, not what went before, and (3) the averages (the tools of the Theory) continually adjust themselves to changing conditions. Each new factor which can possibly affect the economy and corporate profits is sifted, digested, and discounted in the impersonal averages.

THE AVERAGES PREDICT. During January and early February of this year the market declined, but from that time to the present, strength appeared and the averages rallied on good volume. This advance took industrials over their previous highs at A (see chart), but the rails have not followed suit. Until they do, Dow Theorists are entitled to draw bullish inferences (rails have tended to move in the same direction and have held well above their lows), but there must be an eventual rail advance above the A highs (rails 167.38) in order to confirm the validity of the industrial move.

New readers may well ask, "what good is the Dow Theory if it cannot now tell us exactly what the market will do?" Unfortunately, I must reply that each day does not bring forth a fresh prediction of the trend; the Dow Theory simply will not behave like an electric calculator which flashes a new answer as each daily figure is entered. We do not possess a precision device but a barometer which indicates trends when these trends appear. Nevertheless, it is the best instrument we have, and Dow Theorists (in most cases having tried other systems) respect it with all its shortcomings. If I could discover a more perfect method of market

prediction, one that has worked successfully over say a thirty or forty year period, I would immediately switch my allegiance and as promptly change the name of this service.

WHAT IS THE THEORY SAYING NOW? Despite these qualifications the Theory is, at present, saying a number of things, and we will review them now. First, a little understood principle of the Theory states that the last confirmation of the primary trend is taken to continue until reversed by an equally valid counter-signal. In other words, regardless of the present hesitancy, the primary trend is still bullish, and we will take it to remain bullish until certain bearish indications appear. Even then (although we may "jump the gun" and sell out), the primary trend will not be considered to be reversed until a definite bear signal is given in the averages. Applied to the current situation this principle says, "If you are a long term investor, and if you do not attempt to trade the secondary swings, you should continue to hold your stocks. The primary trend continues bullish, and in time (regardless of any reactions) your stocks will go higher."

Next the Theory is saying that we should continue to regard the secondary trend as bullish as long as one or both averages hold above the D lows (indust. 574.46; rails 157.94) of last month. If rails now advance above their January highs (point A, 167.38) thus confirming the industrial penetration, then our bullish inferences will have been proved correct.

We are also told that if both averages turn down and volume tends to diminish as the averages decline, it will be a bullish sign implying that lower prices are not bringing out any real selling pressure. Assuming that one or both averages hold above the D lows on this low-volume decline, we may infer that the next general move will be up. That being the case, we will purchase stocks near the decline lows and call the whole formation a buy-spot.

The Theory tells us that if both averages now decline on increasing volume, we should be on the alert. If the two averages then violate their D lows (particularly on increasing volume) the secondary trend will have turned down, and a further decline or very possibly a second reaction will follow.

All of these things the Theory is saying. Readers who demand more exact predictions free of any alternatives will have to look elsewhere. But they should remember that for sixty-two years this has been the most consistently accurate information available. Those who apply the Theory to the management of their security portfolios will learn to sell stocks for more than they paid for them. If they can do this over a period of time they will be outperforming the vast majority of investors.

THE SOOTHSAYERS. This service could undoubtedly enjoy a much greater circulation if I presented my own unhedged opinion in each letter. That is, until the first serious reversal, at which point this writer would either go the way of other unsuccessful tipsters, or follow the more usual procedure of ignoring the complaints of impecunious subscribers.

Because of research which I am currently undertaking for a series of articles, I have had occasion to examine the past records of many of the leading investment services. It is interesting to read a few random predictions put forth by these services at or about the time of major bear signals. These quotes will serve to demonstrate the fact that investors who go broke have remarkably short memories, and the services who break them have, if nothing else, superior advertising agencies and the courage to go on.

Oct. 28, 1929 (after the bear signal) from one of the nation's largest advisory services: "The investor must have the picture clearly before him--and we must strongly emphasize this point--that the longer range outlook is thoroughly promising. We therefore see no cause for alarm whatever for the investor."

A major service, Sept. 9, 1937 (two days after the bear signal): "Major trend still up." It goes on to say, "...current decline in stock market is temporary...the long pull trend of business and the market is up."

A well-known service advertised in the Sunday press, Sept. 12, 1937 (5 days after the bear

signal): "The test of the Money Managers has now come...this slump will be deliberately checked." In the financial press in large ads, this service announced, "Managed Money Has Made the Dow Theory Obsolete."

One of the nation's largest services, Sept. 18, 1937 (11 days after the bear signal): "Supply demand conditions of business as a whole are unusually favorable. Business should rise sharply during the next several months." Sept. 25, 1937: "Business activity will reach its low within the next week or two and will rise sharply during the remainder of the year." During the next six months, the market and the economy virtually collapsed.

THE PRICE MOVEMENTS. The market is beginning to look stronger. The rails which have given us so much trouble have now formed a series of four ascending bases (D-F-H-I, see chart) and may be in the process of forming a fifth base (K). In the past this has been a most bullish phenomonon. Since the rail average has been the weak sister, I am of the opinion that the next important move may be a rail rally which will better the rail highs at A and bullishly confirm the industrial advance.

It is a sign of technical strength that, despite the Fed's raising of the rediscount rate a full 1/2%, the market has brushed off this news and continued relatively undaunted.

STOCKS. Many subscribers have inquired about my methods of stock selection. The answer is that I use the technical method in stock selection as well as in market prediction. In the same way that Dow Theory is a technical approach to the market as a whole, stock charting is an extension of this method as applied to individual securities. In both cases we are saying, "The charts contain all the available information concerning either a stock or the market. If we can successfully interpret the pattern of these price movements, we will know what that stock or the general market is going to do next."

STOCKS TO BUY. WESTINGHOUSE, GENERAL CONTROLS, RADIO CORP., GENERAL FIRE, OLIN MATHIESON, HERCULES POWDER, MONSANTO, DOW, CORNING GLASS, HOFFMAN ELECTRONICS, BECKMAN INSTRUMENT, ALLEGHANY CORP., EMERSON RADIO, CAMBELL CHIBOUGAMAU. Anaconda and Magma previously recommended have acted well and should be held or bought on any weakness. My charts turned bearish on the international oils last December, and I said at that time that I believed they should be sold. These oils are a good deal cheaper now, and many investors think they are on the bargain counter. This may be the case, but at the present writing I do not see any signs of major reversals in this group. Those who have oils may be justified in holding them at these "depressed" prices in the hopes of an eventual turn in the oil trend. (written March 10, 1959)

NOTICE. The second article in the Dow Theory series is scheduled for next week's issue of BARRON'S. This article will discuss the primary trend, the secondary reactions, and their importance to the investor. I believe this piece will be of interest to all followers of Dow's Theory.